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IN THE
Supreme Court of the United States
OCTOBER TERM, 1997

NORFOLK SOUTHERN CORPORATION,
and affiliated companies;
NORFOLK & WESTERN RAILWAY COMPANY,
and affiliated companies,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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BRIEF OF TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE* TAX FOUNDATION

The Tax Foundation, as amicus curiae, respectfully requests that the Court grant certiorari in this case so that the Court may address the fundamental tax policy issues it presents.[1]

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[1] In compliance with Rule 37.6, the Tax Foundation states that no counsel for a party authored this brief in whole or in part, and that no person other than the Tax Foundation, its members, or its

The Tax Foundation is a nonprofit, nonpartisan policy research organization that has monitored tax and fiscal policies at all levels of government since 1937. In its sixty years of analyzing government tax policy, the Tax Foundation has committed itself to principles which guide its research and public education programs and which it believes should be touchstones for all tax policy. Among those principles is that tax law should be administered fairly, it should be applied in a way which promotes compliance, and it should not be retroactive.

The Tax Foundation has never before filed a brief as an amicus curiae. It has chosen to do so in this instance because it believes that the proper functioning of our tax system is dependent on applying principles of sound tax policy to resolve cases such as this—a case study in the abusive administration of the tax laws.

Similarly, the Tax Foundation very much understands that Supreme Court consideration of a case is appropriate in only a very few instances in which issues of fundamental importance to parties other than the actual litigants, such as the effective administration of the tax system, are at stake. This case presents such an issue: to what standard of conduct should courts hold the Internal Revenue Service ("IRS") to ensure that the tax laws are administered appropriately and not in an abusive manner. The opinion of the court below,[2] the United States Court of Appeals for the Fourth Circuit, underscores the inadequacy of the current standards for judicial review of the conduct of the IRS and highlights the need for judicial refinement of those standards. Moreover, different courts

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counsel made a monetary contribution to the preparation or submission of this brief.

In compliance with Rule 37.2(a), The Tax Foundation states that the Solicitor General and the petitioner have given their written consent to the filing of this brief.

[2] *Norfolk Southern Corp. v. Commissioner*, 140 F.3d 240 (4th Cir. 1998).

of appeals have applied those standards in ways that permit opposite holdings upon identical facts. For those reasons, it is appropriate for the Court to grant certiorari in this case.

ARGUMENT

The Tax Foundation's interest in this case is prompted by broader concerns than the proper interpretation of a particular section of the Internal Revenue Code. The Tax Foundation's principal focus is on an instance of egregious conduct by the IRS in administering the tax law—the IRS attempted to force taxpayers into a settlement by issuing a revenue ruling in 1990 which applied a new statutory interpretation retroactively to the 1981 tax year and which demanded non-existent records that even the IRS stated would be "impracticable" to produce [3]—and the Fourth Circuit's failure to impose any meaningful limits upon that conduct.

If permitted to stand, the Fourth Circuit's opinion will have a detrimental impact far beyond the affected litigants. Retroactively applied changes in the tax system, whether legislative, regulatory, or interpretive, are a curse to taxpayers, to the strength of the economy, and ultimately to tax policymakers and tax administrators. In fact, it is these very types of abuses that recently compelled Congress and the Executive Branch to reform the IRS. In a statement explaining the purpose of the "Internal Revenue Service Restructuring Act", H.R. 2292, 105th Cong., 1st Sess. (1997), a form of which was later enacted as Pub. L. No. 105-206, 112 Stat. 685, House Ways and Means Committee Chairman Bill Archer stated:

> [T]he purpose of H.R. 2292 is to . . . make sure that the IRS applies the tax laws of our country in a fair, equitable, and consistent manner. In fact, current law and sound tax policy require as much. For example, the IRS . . . generally may not impose retroactive regulations; and the IRS should apply

[3] Rev. Proc. 90-10, 1990-1 C.B. 467.

> the tax laws in a consistent and reasonable manner, both among competitors and with respect to specific taxpayers from one year to the next.

Congressional Record, November 13, 1997, at E2356-57. Yet those worthy goals will not be achieved, and the IRS restructuring bill and other tax statutes will be nullified, if courts do not review the conduct of the IRS to ensure that it does, in fact, "apply the tax laws in a consistent and reasonable manner." Therefore, it is critical that the Court ensure that proper standards of judicial review are both established and implemented by the courts below.

Failure to ensure that the IRS applies the tax laws in a fair and consistent manner would be calamitous to our system for the collection of revenues. A taxpayer's sense of civic duty is essential to the operation of the income tax. This sense of duty is maintained, in part, when changes in tax laws are made on a prospective basis only. This prospective treatment establishes a consistency of tax treatment. Because the IRS is charged with the administration, and therefore the preservation of the income tax as a primary revenue source of the Federal government, the IRS has a duty to be consistent in its administration of the tax law. In fact, courts often have acknowledged as much. As Justice Frankfurter observed, "[I]t can be an independent ground of decision that the Commissioner has been inconsistent, without much concern for whether we should hold as an original matter that the position the Commissioner now seeks to sustain is wrong." *United States v. Kaiser*, 363 U.S. 299, 308 (1960) (Frankfurter, J., concurring).[4]

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[4] *See also Bunce v. United States*, 28 Fed. Cl. 500, 508 (1993) ("A duty of administrative consistency certainly exists; the tax laws must be interpreted and applied as uniformly as possible."), *aff'd mem.*, 26 F.3d 138 (Fed. Cir. 1994), *cert. denied*, 513 U.S. 1043 (1994); *Ogiony v. Commissioner*, 617 F.2d 14, 18 (2nd Cir. 1980) ("[C]onsistency over time and uniformity of treatment among taxpayers are proper benchmarks from which to judge IRS actions.") (Oakes, J., concurring), *cert. denied*, 449 U.S. 900 (1980).

Indeed, Congress has determined that retroactive application of the tax laws is so offensive to the principles of sound tax policy that it recently enacted a prohibition on the retroactive application of IRS regulations. In 1996, as part of the Taxpayer Bill of Rights 2, Congress established that the effective date of any temporary, proposed, or final regulation may not be earlier than the date it was published in the Federal Register in temporary form. I.R.C. § 7805(b). Although that statute applied prospectively only, the policy concerns which prompted its enactment are no less applicable in this case.

Confidence that changes in the tax law will only be made prospectively enhances the necessary sense that the tax system is fair. Even a few instances of reported retroactive treatment may suffice to erode this sense of fairness significantly. Just as one need not suffer ill-health to know that a certain activity can be hazardous, so, too, one need not be personally subjected to a current instance of a retroactively applied change in the tax law to be concerned about the possibility. For that reason, the case before the Court is of consequence to many parties other than those who have a direct financial interest in its outcome. In order to ensure proper administration of the tax system, the Court should provide guidance to the lower courts so that they may define the proper bounds to the exercise of discretion by the IRS.

This case presents a particularly egregious instance of retroactive taxation. The key facts are not in dispute. *See, Norfolk Southern Corp. v. Commissioner*, 104 T.C. 13, 15-32 (1995). Prior to the tax year at issue, 1981, the IRS regularly audited container lessors claiming accelerated depreciation and investment tax credits ("ITC") with respect to intermodal containers and expressly approved those tax benefits based on the taxpayers' interpretation of the relevant statute and the records the taxpayer presented. Because the ITC was a major component of the container lessors' tax returns, it was specifically reviewed during those routine audits, and the taxpayers'

claims to the ITC were, in some instances, subject to highly detailed analysis by IRS specialists who thoroughly examined the use of, and documentation relating to, the containers in question. Based on the IRS's well-established audit position, the taxpayers made investment, pricing, and other business decisions involving hundreds of millions of dollars in transactions that could not be subsequently unwound.

The petitioner is the lessee of intermodal containers and the assignee of tax benefits, including the ITC, relating to the containers. As had been the case in prior audits of the lessors' returns, an audit of the petitioner's 1981 Federal income tax return was conducted and closed without the assertion of an adjustment relating to the containers. However, the IRS reopened the audit of appellant's 1981 return in 1985. The audit remained unresolved until 1990, at which time the IRS issued Revenue Ruling 90-9, 1990-1 C.B. 46, which reversed its previous audit positions concerning how companies may claim the ITC and accelerated appreciation on leased containers and imposed new documentation requirements calling for voluminous records which never existed. The IRS declined to apply Revenue Ruling 90-9 prospectively. Instead, it was applied to *all open tax years since the governing statute was first enacted in 1962*. On the day after the IRS promulgated the Revenue Ruling 90-9, it issued Revenue Procedure 90-10, in which it conceded that meeting the record keeping requirements established by Revenue Ruling 90-9 was "usually impracticable" because producing such proof was "disproportionately difficult" and "disproportionately expensive." [5] As an alternative to meeting the onerous record keeping requirements imposed by Revenue Ruling 90-9, Revenue Procedure 90-10

[5] The Revenue Procedure in fact understated the difficulty of meeting this new record keeping requirement. As the Tax Court below observed, the "shipping lines generally did not have the capability to trace the movement of individual containers on a routine basis as required by the Revenue Ruling." 104 T.C. at 25.

permitted a taxpayer to accept a stipulated allowance of the ITC and accelerated depreciation for containers covered by open tax years. For containers placed in service in 1981, Revenue Procedure 90-10 offered a 50% allowance. In effect, Revenue Ruling 90-9 was used as a bludgeon to induce the taxpayer to elect to claim the tax benefits permitted under Revenue Procedure 90-10, which itself constituted nothing more than a formalized settlement offer.

By permitting the IRS's actions in this case to stand, the court below fails to fulfill its judicial responsibility of ensuring that IRS "appl[ies] the tax laws in a consistent and reasonable manner." That failure is due, at least in part, to the inadequacy of the standards of review which the Fourth Circuit seeks to apply. Therefore, it is critical that this Court establish proper standards of judicial review that may be implemented by the courts below in this and other cases.

In this case, the Fourth Circuit states, "Our review of the Commissioner's decision to apply revenue rulings retroactively is for abuse of discretion." 140 F.3d at 247. Although the Fourth Circuit cites *Baker v. United States*, 748 F.2d 1465, 1467 (11th Cir. 1984) as authority for that proposition, it inexplicably fails to apply, or even acknowledge, the detailed criteria identified in *Baker* which should be considered in determining whether retroactive action is permissible. Those criteria, which in turn were adapted from and endorsed by the Fifth Circuit in *Anderson Clayton & Co. v. United States*, 562 F.2d 972, 981 (5th Cir. 1977), *cert. denied*, 436 U.S. 944 (1978), include:

> (1) [W]hether or to what extent the taxpayer justifiably relied on settled prior law or policy and whether or to what extent the putatively retroactive regulation alters that law; (2) the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative reenactment of the pertinent Code provisions; (3) whether retro-

> activity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and (4) whether according retroactive effect would produce an inordinately harsh result.

Those criteria have the dual merits of both affirming sound tax policy and providing detailed guidance, and thus constitute the type of standards which the Court should seek to establish for review of all IRS conduct. Significantly, had those standards of review been applied to the facts of this case, the Fourth Circuit likely would have reached a different result.[6]

The Fourth Circuit opinion acknowledges that the IRS acted retroactively by applying a 1990 Revenue Ruling to the 1981 tax year. 130 F.2d at 247. However, rather than adhering to the precedents of the Fifth and Eleventh Circuits and applying specific criteria to assess the permissibility of the IRS's actions, the Fourth Circuit states the question is whether, in this instance, 'retroactive application [of the Revenue Ruling] is appropriate". *Id.*, quoting *Baker*, 748 F.2d at 1467. Such a criterion, like the "abuse of discretion" standard which it purports to clarify, is so broad as to be meaningless. Similarly, the Fourth Circuit's statement that the IRS may retroactively change its interpretation of the law is of no help. That proposition, though not in dispute, is irrelevant: the issue is whether, upon the facts of this case, the IRS abused its discretion by its retroactive actions.

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[6] In its "Findings of Fact", the Tax Court below stated that (1) the petitioner relied on prior policies; (2) competitors within the container leasing industry enjoyed more favorable tax treatment than the petitioner; and (3) the change in policy would increase the tax liability of the petitioner by millions of dollars. 104 T.C. at 15-32. In addition, in the 19 years between the initial enactment of the ITC in 1962 and the 1981 tax year, the Congress amended the ITC statute numerous times without any change to the container provision, notwithstanding the then-current position of the IRS concerning how the container exception was to be applied. *See, e.g.*, Pub. L. No. 96-605, 94 Stat. 3525, 3528.

Lacking meaningful criteria upon which to base its analysis, the Fourth Circuit's entire discussion of the retroactivity issue consists of making two factual observations, neither of which are supported by the Tax Court's Findings of Fact. First, the Fourth Circuit quotes an excerpt from the IRS's brief which refers to a project initiated by the IRS in 1980 to develop interpretive guidance regarding the statute in question. On that basis, the Fourth Circuit concludes that "the Ruling was developed over ten years" and thus, by implication, the taxpayer had adequate notice of the pending change in the Commissioner's position. 130 F.2d at 247. However, as the Tax Court specifically noted, the IRS closed the project in January of 1992, after meetings with container leasing industry representatives, without issuing any rules or regulations. 104 T.C. at 25-26. Such action hardly constituted notice of a pending change in position. To the contrary, the IRS specifically scrutinized industry practices with respect to claiming the credit and related accelerated depreciation and with respect to record keeping and chose not to require any changes or impose any new substantive or evidentiary requirements. Second, the opinion states that the taxpayer asserted that it was entitled to claim the tax benefits "without maintaining sufficient records to prove them." 140 F.3d at 248. Yet the taxpayer *did* maintain records of its container fleet which were deemed sufficient to demonstrate to the IRS that the taxpayer complied with the statute as interpreted in multiple audits prior to 1981. What the taxpayer did not do was comply in 1981 with the record keeping requirements imposed for the first time by the IRS in its 1990 Revenue Ruling.

The impracticability of meeting the evidentiary standard proposed in the 1990 Revenue Ruling also undermines the Fourth Circuit's interpretation of the statute at issue. The court below states that the "clear" meaning of the statute is one which compels the conclusion that Congress sought to achieve a policy objective—promoting the use of intermodal containers—by enacting a tax credit

which could not be practicably claimed by any taxpayer even on a prospective basis, because the cost of compliance with the excessively burdensome record keeping requirements would exceed the value of the tax benefits. 140 F.3d at 245. To impose those requirements retroactively compounds the absurdity: because the record keeping requirements applied for the first time in 1990 served no purpose other than tax compliance, such records never existed.

The very fact that the IRS's conduct in this case did not, in the opinion of the Fourth Circuit, constitute an "abuse of discretion" underscores that such a standard needs to be further refined.

Of all the facts of this case, perhaps most offensive is the IRS's bad faith in using the rule making process to gain a tactical advantage against taxpayers rather than as a means of providing guidance to those seeking to comply with the Internal Revenue Code. The Revenue Ruling was, in itself, objectionable because it required that taxpayers seeking to claim the tax benefits meet an admittedly "impracticable" evidentiary standard. However, more troubling still is that, the very next day, the Revenue Procedure proposed a safe harbor—in essence, a settlement offer—to taxpayers unable to comply with the Revenue Ruling. Taken together, Revenue Ruling 90-9 and Revenue Procedure 90-10, which were issued in the midst of discussions between the taxpayers and the IRS concerning application of the ITC and accelerated depreciation, must be viewed for what they are—an attempt to pressure the taxpayers into a settlement, and a textbook example of abuse of discretion. Had the IRS sought to act in good faith and provide appropriate guidance, it would have adhered to the standard administrative procedures and issued a regulation of prospective effect only upon giving appropriate notice and providing opportunity for comment.[7]

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[7] The sole regulating to the provision in question, promulgated shortly after enactment of the 1962 statute, "merely repeats the

The facts of this case are not only egregious, they are uniquely so: the retroactive change was imposed for a period which far exceeded those found objectionable by other courts. For example, in *Baker*, 748 F.2d 1465, which the court below cites as authority for applying an abuse of discretion test to retroactive revenue rulings, the 11th Circuit held that the Commissioner abused his discretion by applying a 1980 revenue ruling to the 1977 tax year. That benchmark served to underscore that issuance of Revenue Ruling 90-9, which applied to *all open tax years since 1962*, did, indeed, constitute an abuse of discretion by the Commissioner. The opinion of the court below stating otherwise should not be permitted to stand.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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statutory language", 104 T.C. at 34, and thus affords no guidance. To this day, that regulation has not been revised or amended in any way.